Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author:	Wolk	Analyst:	Scott McFarlane	Bill Number:	SB 401
Related Bills:	See Prior Analysis	Telephone:	845-6075	Amended Date:	April 28, 2009
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Tax Shelters & Tax-Shelter Penalties

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended ____________.

X AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENTS CONCERNS stated in the previous analysis of bill as introduced/amended ____________.

____ FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO ____________.

X REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED FEBRUARY 29, 2009, STILL APPLIES.

X OTHER – See comments below.

SUMMARY

This bill would eliminate inconsistencies in various abusive tax-shelter laws by providing a single, consistent definition for abusive tax shelters (ATS), which would be referred to as “potentially abusive tax avoidance transactions.”

In addition, this bill would:

- Modify the ATS-use penalty to no longer allow taxpayers to avoid the penalty by filing an amended return prior to Franchise Tax Board (FTB) issuing a deficiency notice; instead, this bill would impose 50 percent of the penalty in such situations; and
- Create a new California reportable-transaction category for transactions of interest.

SUMMARY OF AMENDMENTS

The April 28, 2009, amendments would create a new California reportable-transaction category for transactions of interest and would provide that a limited liability company (LLC) or an S corporation would not be determined to be potentially abusive solely based on the formation of such entities; however, an LLC or an S corporation could be determined to be potentially abusive if such entities are used to facilitate a potentially abusive tax avoidance transaction.

Board Position:			Legislative Director	Date
____ S	____ NA	____ NP		
____ SA	____ O	____ NAR	Brian Putler	05/29/09
____ N	____ OUA	X PENDING		

PURPOSE OF THE BILL

The purpose of the bill is to clarify state tax laws that apply to potentially abusive tax avoidance transactions, and to improve the effectiveness of the ATS-use penalty.

EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2010. The operative dates would be as follows:

- The provision relating to transactions of interest would be operative for transactions of interest published on or after January 1, 2010.
- The provision relating to interest suspension would be operative for notices mailed or amended returns filed on or after January 1, 2010.
- The provision relating to subpoenas would be operative for subpoenas issued on or after January 1, 2010.
- The provision relating to the eight-year statute of limitations would be operative for taxable years beginning on or after January 1, 2009.
- The provision relating to the ATS-use penalty would be operative for notices mailed on or after January 1, 2010, and for amended returns filed more than 90 days after January 1, 2010, with respect to the taxable years for which the statute of limitations for mailing a notice of proposed assessment has not expired as of January 1, 2010.

POSITION

Pending.

ANALYSIS

<u>FEDERAL/STATE LAW</u>

Reportable Transactions

A reportable transaction is generally any transaction that has a potential for avoiding or evading tax and the transaction is required to be included a return or statement.[1] Federal and state law require a taxpayer who participated in a reportable transaction to disclose the transaction on an original or amended return for any taxable year the taxpayer participates in the transaction.[2] The current categories of reportable transactions include:

- o Listed transactions;[3]
- o Confidential transactions; [4]
- o Transactions with contractual protection;[5]
- o Loss transactions;[6] and
- o Transactions of Interest.[7]

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[1] IRC section 6707A(c)(1); R&TC section 19772.
[2] Treas. Reg. section 1.6011-4(a); R&TC section 18407.
[3] Treas. Reg. section 1.6011-4(b)(2); R&TC section 18407.
[4] Treas. Reg. section 1.6011-4(b)(3).
[5] Treas. Reg. section 1.6011-4(b)(4).
[6] Treas. Reg. section 1.6011-4(b)(5).
[7] Treas. Reg. section 1.6011-4(b)(6).

Listed Transactions

A listed transaction is a transaction that has been identified by the IRS or the FTB to be a tax-avoidance transaction (i.e. an abusive tax shelter).

Transactions of Interest

A transaction of interest is a transaction that is the same as or substantially similar to one of the types of transactions that the IRS has identified by notice, regulation, or other form of published guidance as a transaction of interest.

THIS BILL

This bill would provide a single, consistent definition for "potentially abusive tax avoidance transactions," which would mean any of the following:

1. A federal tax shelter;
2. An undisclosed reportable transaction;
3. A listed transaction;
4. Any entity, transaction, plan or arrangement that the Secretary of the Treasury of the FTB identifies by regulations, notices, issue papers, or other official public notification as having a potential for tax avoidance or evasion;
5. A gross misstatement; or
6. A transaction subject to the noneconomic substance transaction understatement penalty.

This bill would coordinate this definition of "potentially abusive tax shelters" in the application of:

- The eight-year statute of limitations,
- The ATS-use penalty,
- The interest-suspension rule, and
- The authority to issue subpoenas.[8]

This bill would modify the ATS-use penalty. Current law provides no penalty is imposed if an amended return is filed prior to FTB issuing a deficiency notice. This lessens the effectiveness of the penalty, as most taxpayers file amended returns to avoid the penalty. The penalty would be more effective if taxpayers were instead subject to 50 percent of the penalty by filing an amended return prior to the issuance of a deficiency notice; that way, there would continue to be an incentive to file an amended return and pay the tax, but the most egregious transactions, particularly large-dollar transactions, would still be subject to a significant penalty for having previously reduced tax by the use of abusive transactions.

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[8] R&TC section 19504(c)(2). This section refers to R&TC section 19777 for the meaning of a "potentially abusive tax shelter."

This bill would enact a new California reportable-transaction category for transactions of interest. A transaction of interest would include any transaction that is the same as, or is substantially similar to, a transaction specifically identified by the IRS or FTB as a transaction having a potential for tax avoidance or evasion. Similar to the current federal authority to identify transactions as transactions of interest, this bill would allow the FTB to identify transactions of interest through the use of FTB Notices or other published positions, which would be published on FTB's website.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed, this bill would result in the following revenue gains beginning in fiscal year 2008/09.

Estimated Revenue Impact of SB 401 Assumed operative on January 1, 2010 Assumed Enacted After June 30, 2009 ($ in Millions)		
2008/09	2009/10	2010/11
$3.5	-$3.6	-$1.7

Additionally, transactions of interest are anticipated to increase awareness and could increase taxpayer compliance. Although the impact to revenue in future years is unknown, approximately $600 million in tax revenue would be gained for every one percent increase in self compliance.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

The revenue is estimated using the following revenue streams:

1. The penalty revenue from expanding the definition of "potentially abusive tax avoidance transactions."
2. The accelerated revenue from taxpayers that take advantage of the 90-day period to avoid the ATS-use penalty.
3. The revenue decrease due to allowing a 50-percent reduction in the ATS-use penalty.
4. The revenue increase from transactions of interest.

Estimated Revenue Impact of SB 401 Assumed Operative for Notices Issued On or After January 1, 2010 Assumed Enacted After June 30, 2009 $ in Millions			
	2008/09	2009/10	2010/11
Stream 1	$2.5	$6.3	$8.8
Streams 2 & 3	$1.0	-$9.9	-$10.5
Total *	$3.5	-$3.6	-$1.7

* For Stream 4, see explanation below.

Stream 1:

Revenue from Modifying the Definition of "Potentially Abusive Tax Avoidance Transactions"

Modifying the definition of "potentially abusive tax avoidance transaction" is estimated to increase penalty assessments by $10 million annually (250 cases X $40,000). Because this penalty may be protested, the revenue is anticipated to be collected over three years. Assuming that 50 percent of taxpayers protest their penalty assessments, $5 million ($10 million X 50%) would be collected during the first year. For fiscal year 09/10, this figure is reduced to $2.5 million to reflect only assessments issued after January 1, 2010.

Additionally, providing a consistent definition for abusive tax shelters would create departmental efficiencies, potentially reducing the time needed to develop cases at audit and protest levels. These efficiencies would enable staff to pursue additional tax shelter cases. This estimate does not consider revenue gains that may result from these efficiencies.

Streams 2 and 3:

Reducing the ATS-Use Penalty by 50 Percent for Amended Returns & 90-Day Period

Under current law, taxpayers can avoid the ATS-use penalty by filing an amended return after the department has contacted the taxpayer regarding an undisclosed reportable transaction, a listed transaction, or gross misstatement, but before FTB issues a deficiency notice. The department currently receives approximately $17 million annually in revenue from taxpayers that file amended returns to specifically avoid the ATS-use penalty.

It is estimated that because this bill would allow a 50-percent reduction in the penalty in this situation, some taxpayers would continue to file amended returns voluntarily but not at the volume the department currently receives. This portion of the proposal is estimated to result in delayed revenue collections of $8.5 million ($17 million X 50%) beginning in fiscal year 10/11. This delayed revenue will be realized in future years when the audits are complete.

Additionally, because the change in law would be operative 90 days after the effective date of the legislation, some taxpayers currently under audit are anticipated to file amended returns during this 90-day period to avoid the ATS-use penalty. In the first year, this portion of the proposal is estimated to accelerate approximately $5 million from audits that would be in progress, which would have been completed over the next few years.

Revenue Impact Due to Revenue Streams 1, 2 and 3

Because this bill would affect prior tax years, the revenue estimate for each revenue stream has been accrued back one fiscal year. The revenue estimate for fiscal year 2009/10 consists of penalty revenue collection of $2.5 million (reflected in fiscal year 2008/09). Netting revenue streams two and three results in accelerated payments of $1 million during the first year and this revenue is accrued back to fiscal year 2008/09.

Stream 4

Creating a California reportable-transaction category for transactions of interest is anticipated to increase awareness and could increase taxpayer compliance. Although the impact to revenue in future years is unknown, approximately $600 million in tax revenue would be gained for every one percent increase in self-compliance.

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